

2004 QUARTERLY LAW UPDATE

BANKRUPTCY COURT OPINIONS

Lucre Management Group, LLC v. Schempp Real Estate, LLC (In re Schempp Real Estate); Case No. 03-1927 HRT; Order entered December 19, 2003. The issue in this case was whether to take jurisdiction over a civil case removed to this Court by the Debtor/Defendant shortly after it filed its bankruptcy petition. A little history is in order. The ongoing legal disputes between these, and related, parties has spawned two chapter 11 bankruptcy cases and numerous pieces of civil litigation. The subject of the current litigation is an office condominium project in Adams County, Colorado. Lucre previously owned the property. At least partly due to legal disputes between Lucre and one Mr. Schempp, Lucre defaulted on its deed of trust and the lender started foreclosure proceedings. Lucre filed a short-lived bankruptcy proceeding in 2001. Meanwhile, Mr. Schempp formed Schempp Real Estate, LLC, (“Schempp”) for the purpose of buying that note and deed of trust from the lender. Schempp then obtained a lift on stay in Lucre’s case and foreclosed on the property to become the owner. As one might expect, Lucre then sued Schempp and placed a lis pendens on the property, cutting off Schempp’s ability to market the properties and putting it into financial difficulty. Schempp filed its current bankruptcy case and removed the civil litigation to this Court for determination. Lucre seeks to have the civil case remanded back to state court. This case provides a general discussion of mandatory and discretionary abstention under 28 U.S.C. § 1334(c). Despite Schempp’s attempt to amend its counterclaims asserted in the removed case to recharacterize them as arising under § 544, this litigation involves strictly state court causes of action. The Court found no core bankruptcy matters in this prepetition state court case. As a consequence, the Court’s analysis of the mandatory abstention factors led to a finding that abstention is appropriate. The Court also analyzed discretionary abstention and found that, even if it were not obliged to abstain under § 1334(c)(2), it would use its discretion to abstain under § 1334(c)(1). High on the Court’s list of concerns were: 1) the appearance that Schempp was attempting to invoke this Court’s jurisdiction as nothing more than another litigation strategy in an ongoing legal dispute; and 2) that the interests of comity dictated that the state court is the best forum to decide this case which consisted exclusively of state law issues, including an unsettled “reverse piercing” issue, and that the state court has the strongest interest in addressing issues revolving around real estate within that court’s jurisdiction.

In re Electrical Contracting Services Company; Case No. 03-26582 HRT; Order entered November 6, 2003. In this case, the Court addressed the Debtor’s motion under 11 U.S.C. § 1113(b) to reject its collective bargaining agreement [the “CBA”] with Local 68 of the International Brotherhood of Electrical Workers [the “Union”]. Part of the Debtor’s strategy in the reorganization case is to refocus its business on the market for smaller jobs and service work. It argues that it cannot be competitive in that different market niche if it remains bound to the CBA. Among its other arguments, the Union contended that the motion to reject should be denied because the Debtor took unilateral action to hire replacement workers in violation of § 1113(f) without seeking interim relief from the Court under § 1113(e). The Court did find that the Debtor acted in violation of § 1113(f). However, it rejected a per se rule that would automatically deny relief to the Debtor as a consequence of that violation. The hiring of replacements without seeking interim relief was considered as part of the Court’s analysis of Debtor’s good faith. Given the totality of the Debtor’s actions, the Court ultimately found that the Debtor satisfied the statute’s good faith requirement. But, good faith is only one of the nine elements required under the statute. After examining the remaining elements in light of the evidence, the Court granted the Debtor’s motion.

National Labor Relations Board v. Gordon (In re Gordon); Adversary No. 03-1330 HRT; Order entered December 1, 2003. In this case, the Court denied an NLRB motion for summary judgment. Prior to the bankruptcy, the NLRB obtained a judgment against the Debtor in an administrative proceeding and the Tenth Circuit Court of Appeals issued various orders enforcing that administrative judgment. After the bankruptcy was filed, NLRB filed this adversary action under 11 U.S.C. § 523(a)(6). In its summary judgment motion, NLRB argued that it was entitled to judgment in its favor by means of collateral estoppel. The Court did apply collateral estoppel to make certain findings based upon the judgment in the administrative proceeding. The Court found that Gordon intentionally discharged his union workers; that he did so in order to convert his business from a union operation to a non-union operation; that Gordon committed unfair labor practices under § 8(a) of the NLRA; that his employees were injured by those unfair labor practices; and the amount of damages suffered by those employees. But the factual issue of Gordon's specific intent was not established by the record in the administrative proceedings. The Supreme Court case of *Kawauhau v. Geiger*, 523 U.S. 57, 118 S. Ct. 974 (1998), requires the Court to find that Gordon's actions were committed with an intent to harm the employees. But, with nothing in the record of the administrative proceedings to establish that specific intent, the Court could not find that NLRB had established all of the elements necessary for it to be entitled to judgment under § 523(a)(6). Nonetheless, the doctrine of collateral estoppel would prevent the Defendant from re-litigating many factual issues that have been previously decided and the remaining issue for trial could be narrowed down to the question of whether Gordon acted with a specific intent to harm his workers.

Congress Financial Corp. v. Airwalk International, LLC (In re Airwalk International, LLC); Case No. 03-32709 HRT; Order entered December 11, 2003. On November 13, 2003, a group of three far eastern footwear and apparel manufacturers filed an involuntary chapter 11 petition against Airwalk International, LLC, (Airwalk) claiming debts in excess of \$13 million. Congress Financial ("Congress"), a secured creditor, was in the process of completing a proceeding in New York state to foreclose its security interest in substantially all of Airwalk's assets. Those assets consist largely of patents, copyrights and licensing agreements. The involuntary petition stayed that proceeding. Following shortly upon the heels of the involuntary petition, this relief from stay action was filed for the purpose of allowing Congress to complete the foreclosure. The relief was vigorously opposed by the proponents of the involuntary petition. As of the petition date, Airwalk owed Congress about \$14 million. Sunrise Capital Partners, LP, ("Sunrise") had a second position lien in the assets and was owed about \$91 million. Sunrise is also the 100% owner of Airwalk's stock and formed the entity which submitted the high bid of \$26 million at the foreclosure sale for all of Airwalk's assets. The Court allowed the objecting creditors to present evidence to support their theories that the Sunrise debt should be equitably subordinated or recharacterized as an equity contribution. But the creditors failed to present persuasive evidence to support those defenses. In light of the apparent value of the assets, as determined by the high bid at the New York foreclosure sale, and the amount of the debt which those assets secured, the Court found no equity in the assets and that no reorganization was in prospect. It granted the relief..

In re Freddie I. Barker, d/b/a JDW Ranch, and Sharlene R. Barker, Case No. 03-12543 HRT, Order Granting Creditor's Motion to Abandon, entered on October 21, 2003. This case illustrates the pitfalls faced by some debtors after the stay is lifted to allow a creditor to foreclose on the debtors' property. The Barkers own substantial property which either has been largely depreciated for tax purposes over the years or has greatly appreciated in value over the property's tax basis. Thus, the Barkers estimate that a sale of their property would yield a capital gain tax liability of \$185,901.00. However, the property is fully mortgaged. All of the proceeds generated by a sale of the property will go to pay off the mortgages. The secured creditor has obtained a lift of stay in order to move forward with its foreclosure action. Even though the stay has been lifted, the property remains property of the bankruptcy estate until it is abandoned or the estate is closed. The

consequence to the Barkers of granting the motion to abandon is that they would then be the owners of the property whenever a foreclosure sale takes place. That would make them responsible for the \$185,901.00 capital gain tax liability. If the property is not abandoned, and is property of the estate at the time of a foreclosure, then the estate becomes responsible for the income tax on the capital gain. Despite the dismaying predicament that abandonment creates for the Barkers, the only issue for the Court was to determine, under 11 U.S.C. § 554, whether the property was burdensome or of inconsequential value to the estate. Considering the lack of equity in the property, and the large capital gain tax liability the estate would incur if the Court were to deny abandonment, the Court determined that abandonment was in order.

In re Mel T. Nelson; Case No. 03-10887 HRT; Order Sustaining Trustee's Objection to Exemption; entered on October 1, 2003. This proceeding is merely the latest chapter in ten years of litigation between Debtor and one John Pico. In a state court suit, Debtor recovered a judgment against Pico in excess of \$10 million. The dispute stemmed from the 1991 sale of Debtor's car dealership. Pico acted as broker for the deal gone wrong. Debtor claimed exemptions with respect to two elements of the judgment: 1) \$6.1 million awarded on a breach of fiduciary duty claim exempted under COLO. REV. STAT. § 13-54-102(1)(n) as proceeds from a claim for personal injury; and 2) \$250,000.00 of the award on an intentional interference with prospective business relations claim exempted under COLO. REV. STAT. § 13-54-104 as earnings. Trustee objected. The Court sustained Trustee's objections and disallowed both claims of exemption. The Court examined the instructions given to the jury and found that the entire amount of the \$6.1 million figure was awarded for Debtor's economic loss. Thus, that damage award compensated Debtor for an injury to his property as opposed to his person. The Court also looked at the instructions relating to the intentional interference claim. It found that those damages were awarded to Debtor because the jury found that Pico's actions prevented the Debtor from entering into a contract to provide services to the buyer of the dealership after completion of the sale. The statute defines wages as compensation paid in return for personal services. But no personal services were ever provided due to Pico's interference. Consequently, those damages did not qualify as wages.

In re Jerry Bevan Rouse and Deborah Lynn Rouse, Case No. 03-20684 HRT, Order Denying Motion for Relief from Automatic Stay, entered September 24, 2003. In this Chapter 13 case, the Debtors' pre-petition bad acts did not constitute "cause" for stay relief. The Bank alleged that Debtors had fraudulently obtained a home equity line of credit from the Bank by providing false social security numbers on their loan application. The Bank presented evidence that the social security numbers provided by the Debtors were not their own and the Court did not find the Debtors' explanation of the discrepancy to be credible. Nonetheless, it was not necessary for the Court to determine whether or not Debtors' pre-petition conduct was fraudulent. Even if it was, that conduct, in and of itself, does not establish "cause" under 11 U.S.C. § 362(d)(1) to lift the stay. The Court found that the Bank enjoyed a \$55,000.00 equity cushion in the real estate and the Debtors had proposed a plan that would, if successfully completed, provide full payment to the Bank. Under these circumstances, the Court found the Bank's interest to be adequately protected. The Court balanced the harm accruing to the Bank from continuation of the stay against the hardship to the Debtors if the stay is lifted. In light of the Bank's well protected equity position, the Court found that, at this early stage of the chapter 13 case, lifting the stay would cause the Debtors greater harm than the harm suffered by the Bank by continuation of the stay.

Expeditors International of Washington, Inc. v. The Liquidating Trust, as transferee of the interests of the Estate of Schwinn Cycling and fitness, Inc. Expeditors International of Washington, Inc. ("Expeditors") filed a complaint seeking a determination that it held a perfected security interest in goods or proceeds of goods to secure repayment of a prepetition debt incurred for shipping services it provided to

Schwinn. Schwinn, in opposition to the Complaint, argued that the strong arm powers of the trustee afforded by 11 U.S.C. § 544 trumped Expeditors' security interest because Expeditors had permitted its perfection in the goods and proceeds to lapse. The parties submitted the dispute to the Court on undisputed facts. They agreed that Expeditors held a perfected security interest in the goods and related documents of title by possession before and, on the petition date, by reason of the twenty day grace period provided for in UCC § 9-312(f). (That provision of the UCC affords a secured party a twenty day grace period from the time it relinquishes possession of collateral to the debtor within which to file a financing statement and thereby maintain continuous perfection.) Prepetition, Expeditors released the goods in its possession to Schwinn, Schwinn sold the goods in the ordinary course of its business, but Expeditors never filed a financing statement. The issue before the Court was whether Expeditors' security interest in the goods and any proceeds thereof, which was perfected as of the commencement of the case, (the date in section 544 of the Bankruptcy Code which triggers the powers of the Trustee) remained perfected post-petition indefinitely or lapsed back to the prepetition date when Expeditors released the goods to Schwinn because Expeditors did not file a financing statement in accordance with UCC § 9-312(f). HELD: Based on: (1) the analysis of the Tenth Circuit in *In re Reliance Equities, Inc.*, 966 F.2d 1338 (10th Cir. 1992); (2) UCC 9-308(c), which governs continuity of perfection by different methods of perfection; and (3) the Official Comment to UCC 9-308(c), Expeditors' security interest lapsed to the prepetition date when it relinquished possession of the goods to Schwinn allowing the strong arm powers of section 544 of the Bankruptcy Code to avoid Expeditors' security interest. Summary judgment was granted in favor of Schwinn and against Expeditors. [Expeditors filed a Notice of Appeal to the District Court on September 15, 2003.]

Grand Prix Motorsports, Inc. v. Tome (In re Tome), Adversary No. 02-1567, Order entered August 5, 2003. The Plaintiff moved for summary judgment on the basis of collateral estoppel and the motion was denied. Plaintiff had obtained a default judgment against Debtor in the state court. Debtor was the service manager at a motorcycle repair shop. It was alleged that he took cash directly from customers for repair work done by the shop. Plaintiff brought a fraud action in the state court and obtained a judgment by default. Following the filing of Debtor's bankruptcy petition, Plaintiff timely filed this dischargeability complaint pursuant to 11 U.S.C. § 523. Judge Tallman held that the judgment relied upon by the Plaintiffs could not be given preclusive effect because the issues were not fully and fairly litigated in the state court forum. Other jurisdictions will give preclusive effect to a default judgment where there was no participation by the defendant in the state court proceedings. See, e.g., *In re Cantrell*, 329 F.3d 1119, 1123-24 (9th Cir. 2003); *Matter of Caton*, 157 F.3d 1026, 1028-29 (5th Cir. 1998). This case, however, recognizes the rule in the Tenth Circuit, applying Colorado law, that collateral estoppel is not applicable where a litigant takes no part in the previous litigation and a default judgment is given without presentation of evidence and factual findings by that court.

Hajiaghvae v. Soufiani (In re Soufiani), Case No. 02-1522 HRT, Order entered August 4, 2003. As much as anything, this case illustrates the pitfalls of defending an adversary action without benefit of counsel. The Court found in favor of the Plaintiff, Debtor's former spouse, on her complaint to except from discharge Debtor's obligations to make payments on a second mortgage loan (secured by property the Plaintiff received in the divorce) and his obligation under the divorce decree to pay Plaintiff's attorney fees. The parties agreed that the obligations were not meant to be in the nature of support and the complaint was brought exclusively under 11 U.S.C. § 523(a)(15). The original amount of the mortgage debt was \$27,000.00 and the original amount of the attorney's fee was \$5,000.00. Between the time of the divorce and the filing of the bankruptcy petition, Debtor had paid nearly \$20,000.00 on the mortgage debt and \$2,500.00 of the Attorney's fee. Once the Plaintiff had established that the debts in question resulted from an order of a domestic court, it was Debtor's burden to prove either: 1) that he lacked the resources to pay the debt and also reasonably provide for himself and his dependents; or 2) that his benefit from discharging the debt would

outweigh the detriment to the Plaintiff. Debtor failed to carry his burden. Debtor testified that his auto body and paint business had failed and that the assets had been sold. It appeared from the testimony that he was still working at the business to finish up some work, but he failed to present any testimony from which the Court could determine his current income or his reasonable expectations for the future. Debtor failed to present any information regarding his current expenses and needs of his dependents, if any. The paucity of evidence offered by the Debtor left the Court with insufficient information from which it could find that Debtor lacked the ability to pay the debts in question and insufficient evidence from which the Court could find that the balance of the equities favored the Debtor. As a consequence, the Court must find in favor of the Plaintiff.